الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Republic of Turkey

August, 2016

TRUST . TRANSPARENCY . INDEPENDENCE

The Republic of Turkey ('Turkey' or 'the country') is the 18th largest economy in the World, featuring a GDP of USD 800b. Given per capita GDP of around USD 10,500, the country is categorized among the upper middle income countries of the World as per the World Bank classification. The country boasts a relatively diversified GDP, with the services sector being the most significant contributor (2/3rd), followed by industrial (>1/4th) and agricultural sectors (<10%). The country's major industrial output includes textile, processed food, automobiles, electronics and a number of commodities such as steel, petroleum, lumber etc.

Table 1: Economic Indicators	2014	2015	2016 (P)
GDP Growth Rate[1]	4.2%	2.9%	4.0%
Inflation[2]	7.5%	8.9%	7.7%
Current Account Deficit (% of GDP)[3]	7.7%	5.5%	4.5%
Foreign Reserve(USD Billions)[4]	131.0	127.3	110.5
International Investment Position (USD Billions)[4]	-395.6	-440.4	-367.4
Public Sector Debt (% of GDP)[3]	36.1%	33.5%	32.9%
Public Sector External Debt (% of GDP)[5]	14.7%	15.0%	15.9%
FDI (% of GDP)[3]	1.7%	1.1%	1.2%
Unemployment	9.0%	9.9%	10.3%

Having achieved significant growth for about a decade (2002-2012), which averaged at 5.2%, growth momentum has moderated over the past few years. Key issues facing the country include an unfavorable trade balance, continued currency depreciation, extensive reliance on foreign funding, turbulence on the southern border and deterioration in security condition. The political uncertainty of 2015 also contributed to the dip in average monthly consumer confidence index3 72.5 in 2014 to 62.3 in 2015.

The large young population base and the resultant strong demand dynamics have supported the country's economic resilience; the GDP growth for 2015 was registered higher than the forecasts at 4.0%. Keeping in view Turkey's vulnerability to expected contraction in Fed's monetary policy and its prevailing socioeconomic conditions, the GDP growth is expected to remain range-bound within 3-4% over the short to medium term horizon. Recent political developments in Turkey may precipitate economic challenges and require caution towards exposures on vulnerable or speculative sectors of the economy

Following a period of consistently high inflation levels, it has slowed to a three year low at 6.57% in April 2016, leaving room for the central bank to cut interest rates and align its monetary policy with the government focus on incentivizing growth. Economic slowdown in major markets (EU & China) has kept pressure on exports despite improved competitiveness as a result of Lira depreciation. However, current account position has benefited from low oil prices with the deficit reducing to 4.5% of GDP in 2015.

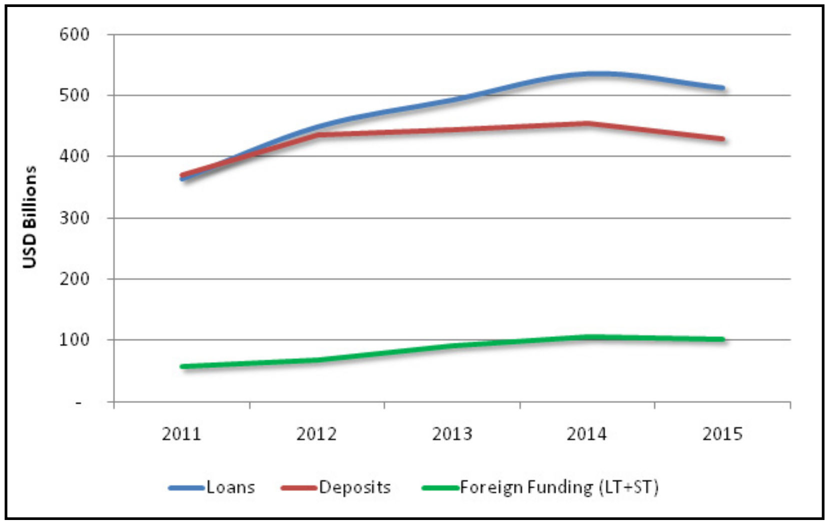
Given the consistent current account deficits posted over the years, foreign reserves have trended down on a timeline basis, albeit remain sizable in relation to the quantum of current account deficit. Overall gross debt to GDP, at 55%5, is considered manageable; nevertheless a sizable proportion (>70%) of this debt pertains to the private sector, which exposes the economy to the risk of sudden accelerated capital outflows.

Banking Sector

The banking sector in Turkey comprises a total of 53 institutions, which include 34 deposit banks, 13 development banks and 6 participation banks. It dominates the country's financial sector, with its asset base of USD 808b comprising more than 70% of the financial sector assets. Despite reporting a CAGR of 19% over the past decade, industry assets comprise about 111% of the GDP, trending considerably below the Euro area average of more than 300%, reflective of room for

[1] *Source: Turkish Statistical Institute*
[2] *Source: The Undersecretariat of Treasury*
[3] *Source: Central Bank of the Republic of Turkey*
[4] *In USD terms*
[5] *Includes 32 member states of European Banking Federation*

growth. Historically, the sector has generated considerable interest from international investors, and has on an average accounted for more than 10% of the Foreign Direct Investment (FDI) over the past few years. As of Sep'15, foreign investors held about 32% shareholding stake in the industry.

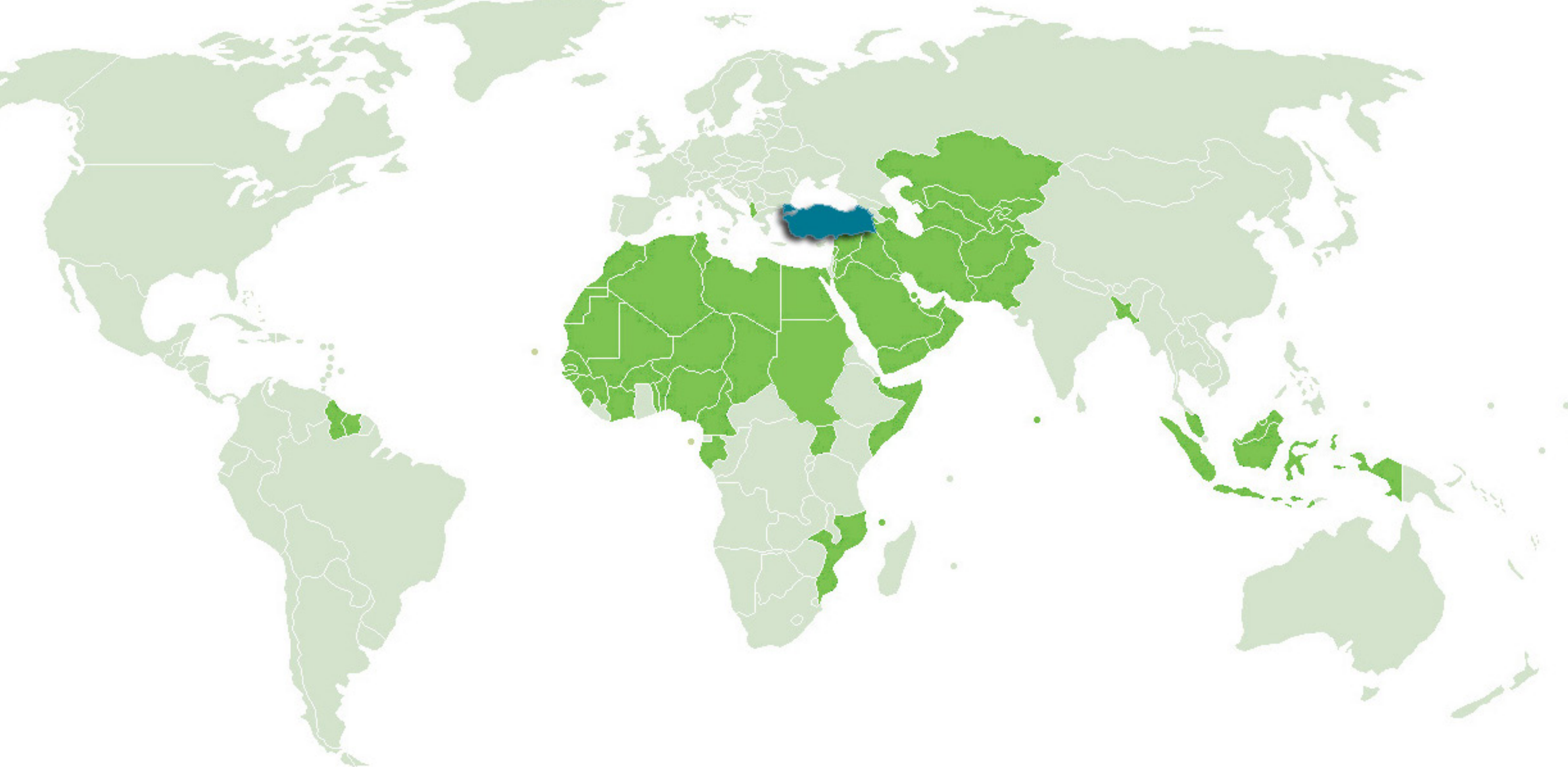


Turkish banking sector derives strength from its strong capitalization, adequate asset quality and sound profitability indicators, though these have depicted unfavorable trends in recent periods. The trend of loan growth outpacing deposit growth continued in 2015 with the loan to deposit ratio increasing to 119% by the year-end. Credit growth in 2015 has softened relative to prior years, and actually showcased a dip in foreign currency terms, given reduced funding availability. The banking sector has historically featured a high reliance on foreign funding. However over the last year, the sector's access to foreign funding has diminished given domestic and external macroeconomic changes, including TL depreciation and expectations vis-à-vis US monetary policy. TL funding also remains stressed given low savings rate and increasing competition. Growth momentum in the past few years has been mainly fueled by consumer and SME loans. Of the banking sector's total financings portfolio, these segments account for about a quarter each, while corporate loans comprise the other half. With lower funding availability, credit off take may be scaled back going forward.

In the latest Regulatory Consistency Assessment Programme (RCAP) report, issued by Basel Committee on Banking Supervision (BCBS) in Mar'2016, the country's banking sector has been graded 'C' and the underlying components of the risk-based capital framework are assessed as compliant. This was achieved subsequent to the 16 new regulations announced by Banking Regulation and Supervisory Agency (BDDK) in Feb'16.

Participation Banking Sector

Specialized Participation Banking (PB) rules and regulations were promulgated in 2005 in Turkey. Previously, companies offering related services were operating under restrictive Specialized Finance House licenses. Since the promulgation of regulations, the sector has grown at a high Compound Annual Growth Rate (CAGR) of 28%; however, its market share remains small at 5% in total banking sector assets. Lately, there has been increased focus on growing the sector given the government's bid to create an Islamic finance center in Istanbul. Accordingly, a separate Participation Banking division has been setup at Banking Regulation & Supervisory Agency and two large state-owned banks have established sister participation banking units. The vision, as documented in the 'Participation Banking Strategy Document' published by Participation Banks Association of Turkey, remains focused on increasing the sector's share in total assets to 15% by 2025.



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